



PHILIP D. DEFEO  
CHAIRMAN  
CHIEF EXECUTIVE OFFICER

VIA FACSIMILE and U.S. MAIL

September 2, 2003

4-469

Ms. Annette L. Nazareth  
Director, Division of Market Regulation  
Securities and Exchange Commission  
450 Fifth Street, N.W.  
Washington, D.C. 20549

**Re: Multiple Trading of Certain Index Products**

Dear Ms. Nazareth:

The International Securities **Exchange** ("ISE") has petitioned the Commission to engage in rulemaking to prohibit an options exchange from being a party to an exclusive or preferential licensing agreement with respect to index options and options overlying other instruments whose value is based on an index.<sup>1</sup> The Pacific **Exchange**, Inc. ("PCX") fully supports the ISE petition and completely agrees with its analysis underlying the Petition. Briefly, **we** believe the beneficial effects of multiple trading of index products would be enormous, and most of these benefits would go to customers in terms of lower transaction costs for these products. Not only do customers pay directly for access to exclusively listed options product (which they do **not** for multiply listed products), but they also **pay** indirectly in the form **of** the higher transaction costs, such **as** spreads in markets that **are not** fully competitive.

For these reasons, we encourage the Commission to publish **for** comment the rule described in the ISE Petition. **We** are concerned, however, that the publication by the Commission of such a rulemaking **proposal would** encourage index licensors and certain options markets **to** rush to enter into exclusive licenses, **before** the Commission could **adopt** any limit on exclusive licenses. Indeed, we have seen some evidence that the very **filing of** the Petition, which is a public document, may have had this effect. For **example**, we were recently informed **by** the Nasdaq Stock Market, Inc., ("Nasdaq") that it is **unwilling** to enter into a licensing agreement with the PCX with respect to two separate options products relating **to** an index, because Nasdaq may have entered into an exclusive agreement with another market with respect to such options. **Any** such "race to the bottom" would exacerbate **the** negative effects of the restraints on competition, including especially higher transaction costs **for** customers, that exclusive deals represent, and could significantly reduce the effectiveness **of any** rulemaking the Commission might eventually decide to undertake in this **area**.

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<sup>1</sup> Letter from David Krell, President **and** Chief Executive Officer, International Securities Exchange, to Jonathan G. Katz, Secretary, Securities and Exchange Commission, dated November 1, 2002.

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As the Commission knows from its multiple listings initiatives with respect to individual stock options, exclusive listings encourage anticompetitive behavior, the effects of which extend beyond the product exclusively listed. Specifically, exclusive listings **lead** to hidden order routing biases on the **part** of order entry firms, who tend to route order **flow even** in products not exclusively listed to a market **with** an exclusive listing in **products** that become heavily traded. Like the ISE and the Commission, the PCX supports clarity with respect to the factors that motivate order flow decisions, and exclusive listings lead to the same kind of obfuscation of an agent's order routing decisions **as does payment for order flow**.

For these reasons, we encourage the Commission immediately to order a temporary moratorium on the commencement of trading of options products subject to exclusive licensing arrangements. Such a temporary moratorium would not affect the markets for any products currently traded; would not affect the validity of any exclusive listing agreements already entered; and would be limited to preventing index products subject to exclusive licenses but not yet actually trading from being introduced into the market and, therefore, further spreading **the** negative effects to customers of non-competitive trading of index options products, until the Commission can **make** a determination on the ISE Petition. Should the Commission determine not to publish the ISE proposal for notice and comment, or even as a concept release, **the** Commission could, at that time, lift the moratorium. Of course, should the Commission determine to publish the Petition, in the form either of a concept release or a notice of proposed **rule** making, we **also** would encourage the Commission to continue any such moratorium in effect during the notice and comment period and prior to any Commission action on the Petition;

We appreciate the Commission's continuing focus on obtaining the benefits to customers of competition among markets, and **hope** that you will view the suggestion contained in this letter as consistent with your efforts in this area.

Sincerely,



Philip D. DeFeo  
Chairman and Chief Executive Officer

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cc: The Honorable William H. Donaldson  
The Honorable Paul S. Atkins  
The Honorable Roel C. Campos  
The Honorable Cynthia A. Glassman  
The Honorable Harvey J. Goldschmid  
The Honorable Richard **Baker**  
The Honorable Barbara **Boxer**  
The Honorable Christopher J. Dodd  
The Honorable Michael B. Enzi  
The Honorable Dianne Feinstein  
The Honorable Barney Frank  
The Honorable Paul E. Kanjorski  
The Honorable Michael G. Oxley  
The Honorable Nancy Pelosi  
The Honorable Paul S. Sarbanes  
The Honorable Richard C. Shelby  
Jonathan G. Katz  
William J. Brodsky – Chicago Board Options Exchange  
Meyer S. Frucher – Philadelphia Stock Exchange  
Salvatore F. Sodano – American Stock Exchange  
David Krell – International Securities Exchange, Inc.